United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-2614
74-2657
75-7010

B
P/S

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

against

GEON INDUSTRIES, INC., et al.,

GEON INDUSTRIES, INC. and GEORGE O. NEUWIRTH,

Defendants-Appellants,

FRANK BLOOM and EDWARDS & HANLY,

Defendants-Appellees.

On Appeal from the United States District
Court for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

LAWRENCE E. NERHEIM
General Counsel

DAVID FERBER
Solicitor

RICHARD E. NATHAN
Assistant General Counsel

VAN P. CARTER
Attorney

INDEX

Page

CITATIONS

Cases:

Page

Cases (continued):

Statute and Rule:

Page

Statute and Rule (continued):

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 74-2614, 74-2657, and 75-7010

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

GEON INDUSTRIES, INC., et al.,

GEON INDUSTRIES, INC. and GEORGE O. NEUWIRTH,

Defendants-Appellants,

FRANK BLOOM and EDWARDS & HANLY,

Defendants-Appellees

On Appeal from the United States District
Court for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

ISSUES PRESENTED FOR REVIEW

1. Where a registered representative of a broker-dealer partnership, acting in the course of his employment, violated §10(b) of the Securities Exchange Act and Rule 10b-5 by trading in and inducing customers to trade in a security on the basis of inside information, and the firm enjoyed profits from the commissions made on these trades, for purpo[illegible] of determining whether an injunction should issue against the [illegible]

(a) May the broker-dealer partnership be held to have violated these antifraud provisions on the basis of respondeat superior?

(b) Should the broker-dealer partnership be held to have been an aider and abetter of the violation, (i) when it permitted the registered representative to deal in the security although that security had not theretofore been considered elegible for trading at the firm, and, indeed the firm gave him special treatment because of the substantial commission income he had produced, and (ii) the registered representative's supervisors, including a partner, conformed their own trading in the security to the pattern of trading by the registered representative, knowing of the continuous contacts the registered representative had with chief executive officer of the issuer?

Statute and Rule in Issue

Section 10(b) of the Securities and Exchange Act, 15 U.S.C. 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--
>
> * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 CFR 240.10b-5, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASES

Preliminary Statement

No. 75-7010 is an appeal by the Commission from an order of the United States District Court for the Southern District of New York, Bonsal, J., entered on October 15, 1974, insofar as it dismissed an injunctive action by the Commission against defendants Edwards & Hanly, a registered broker-dealer firm, and Frank Bloom, financial vice-president, comptroller, treasurer and secretary of Geon Industries, Inc. The district court's opinion is reported at 381 F. Supp. 1063.

In this action the Securities and Exchange Commission sought to enjoin further acts and practices in violation of the federal securities laws, including the antifraud provisions of Se[illegible]on 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and of Rule 10b-5 thereunder, 17 CFR 240.10b-5. 1/

1/ In its complaint the Commission also alleged violations by defendants Rauch and McMahon of the margin requirements of Section 7(c) and (f) of the Securities Exchange Act, 15 U.S.C. 78g(c) and (f), and Regulations T and X promulgated thereunder, 12 CFR 220 and 224. That portion of the complaint is not at issue on this appeal.

In the opinion (52a-71a)[2/] upon which the order under review (72a-74a) was entered, the district court, after a trial held in June 1974, found that defendant George O. Neuwirth, the Chairman of the board of directors and chief executive officer of defendant Geon Industries, Inc.,[3/] had violated the antifraud provisions of the Securities Exchange Act when he furnished material non-public information to defendants Marvin Rauch and Roy Alpert regarding the possible acquisition of Geon by Burmah Oil Company, Ltd., and regarding the progress of negotiations relating to that acquisition. Geon was also held liable for the violations committed by Mr. Neuwirth, its chief executive officer.

2/ The appendix is published in five volumes. Volume I contains the relevant docket entries, pleadings, the district court's opinion that was entered on September 23, 1974, the district court's Judgment of October 21, 1974, and the exhibits designated for inclusion in the appendix. References to Volume I of the appendix are noted as "_a." Volumes II through V contain the transcripts of the trial held June 17 through 21 and June 27, 1974, and references to these volumes are denoted by volume and page, *e.g.*, "II__".

3/ Mr. Neuwirth has voting control of 28 percent of the outstanding shares of Geon. (II.176-177). Mr. Neuwirth's son, Peter, is President of Geon (II.20).

In Nos. 74-2657 and 74-2614, Geon and Mr. Neuwirth have appealed from the injunctions entered against them.[4/]

As indicated above, the district court dismissed the Commission's complaint as against defendants Frank Bloom and Edwards & Hanly. The district court held that Mr. Bloom, Geon's financial vice president, controller, treasurer and secretary (II.17), had not violated the antifraud provisions of the Securities Exchange Act in his response to a representative of the American Stock Exchange, prior to the opening of trading on February 22, 1974, inquiring whether Mr. Bloom knew of any reason why there was then a large imbalance of sell orders in Geon's common stock. Mr. Bloom had denied the existence of corporate developments that might account for unusual market activity in Geon stock, had denied that there had been any change in the status of the proposed merger of Geon with Burmah Oil Co. that might account for the sell orders and had omitted to disclose material accounting errors that were then known or suspected, the correction of which would adversely affect Geon's earnings for 1973 and likely

---

4/ Pursuant to Scheduling Order No. 4, dated March 11, 1975, the briefs of Geon and Mr. Neuwirth in support of their appeals are to be filed on or before April 25, 1975.

eliminate the possibility of the merger.

The district court also held that the Commission had failed to prove a violation of the antifraud provisions of the federal securities laws by defendant Edwards & Hanly, a registered broker-dealer firm. It ruled that the Commission had not proven either (1) that Edwards & Hanly "participated in or knew of . . . [the] misconduct" of defendant Marvin Rauch, one of its securities salesmen, who had effected transactions in Geon stock based on his knowledge of material non-public information, and who had aided and abetted violations of the federal restrictions governing the purchase of securities on margin, or (2) that the firm had "not exercise[d] reasonable supervision over Rauch" (71a).[5]

5/ Prior to the commencement of the trial, defendants Roy Alpert and Irving Alpert, persons not associated with Geon who were alleged to have traded in Geon's common stock on the basis of material non-public information provided by Mr. Neuwirth, consented to the entry of permanent injunctions against future violations of the antifraud provisions of the federal securities laws.

Defendants Marvin Rauch and James McMahon, controller of a Geon subsidiary, and a customer of Mr. Rauch, announced to the court at the commencement of the trial that they too would consent to the entry of permanent injunctions, although their consents were not in fact submitted until after the conclusion of the proceedings.

The Facts

Merger discussions between Geon Industries Inc. and Burmah Oil, Ltd; Purchases of Geon stock by Marvin Rauch and others

Geon Industries, Inc. is a publicly held company (II.20; III.309) that is engaged in the importation and distribution of foreign car replacement parts. (II.17-18).[6/] In late July, 1973, Geon retained Drexel-Burnham & Co., a registered securities broker-dealer, to arrange for discussions concerning a possible merger between Geon and a British company, Burmah Oil Co., Ltd. (II.180, SEC Exhibit 11). After a round of preliminary discussions (II. 20-25), Burmah requested a management forecast from Geon on the future of the automobile replacement part industry, five-year pro forma income and balance sheet estimates and an accompanying cash flow projection (II.26). Frank Bloom, the financial vice president of Geon, was designated as the "liaison" officer to compute and transmit this information to Burmah. (II.27).[7/]

6/ The Company has two export divisions, four major distribution facilities, 103 or 104 company-owned distributor locations throughout the United States and an export subsidiary in Germany. (II.18). For the year 1973, Geon's sales totaled approximately $48,000,000. (III.308). Geon's common stock is traded on the American Stock Exchange (II. 20).

7/ In order to keep their negotiations secret, code names had been adopted with Geon referring to Burmah as "Max" and Burmah identifying Geon as "Banker." (II.196).

After two additional meetings and the transmittal of a second set of pro forma accounting information (II.29-31), Burmah informed Geon in mid-October of 1973 that it had some preliminary interest in forming a business combination and wanted to pursue its investigation. (II.33-35).

At about this time, George and Peter Neuwirth had planned to take a trip to England. Mr. Bloom suggested that Geon take advantage of this proposed trip to send its representatives to Burmah's headquarters "to find out just what kind of company they [Burmah] were." (II.35). Before he traveled to England, however, George Neuwirth had dinner with a long-time friend and business associate, Roy Alpert. (II.210, 212, 214-215; III.318-320, 322). After dinner, Mr. Neuwirth revealed to Mr. Alpert and others that he was going to London not only "for the auto show," but also to "perhaps look[] at some people in view of a merger." (II. 215; III.322-323).

Within a week after that dinner, and as a direct result of Mr. Neuwirth's disclosure of a possible merger (III.323), Mr. Alpert purchased approximately 2,600 shares of Geon's common stock (III.325) — his first purchase of Geon's stock since 1969, when he had acquired 250 shares at the time Geon's securities were first publicly sold. (III.320-321). Mr. Alpert also informed his two brothers, Irving and Edward, of his acquisition and they

purchased Geon's common stock at approximately the same time. (III.325).

Before going to England, Mr. Neuwirth had also spoken with defendant Marvin Rauch concerning a recent market report on Geon (III.220). Within the following few days Mr. Rauch had purchased an aggregate of 1,100 shares of Geon stock for several of his customers (SEC Exhibit 17, 109a).[8/]

After Mr. Neuwirth returned from England on October 31, 1973, he spoke frequently with Mr. Rauch on the telephone (III.232-233). Between November 2 and November 20, 1973, Mr. Rauch purchased 1,900 shares of Geon's common stock in his wife's name (SEC Exhibit 17, 109a-110a).[9/] During the same period James McMahon, the controller of Geon Intercontinental Corporation, a subsidiary of Geon Industries, Inc., purchased an additional 600 shares of Geon's common stock (SEC Exhibit 17, 109a) in an account that he opened through Mr. Rauch in the name of "Louis Maione" (IV.620-621, 623, 628; SEC Exhibit 19, 20, 119a-122a), Mr. McMahon's father-in-

---

8/ Although Mr. Neuwirth met Mr. Rauch in 1969 (III.233-234), it was not until Mr. Rauch joined the firm of Edwards & Hanly that he began to telephone Mr. Neuwirth (III.234), who acknowledged that he knew that Mr. Rauch was "actively engaged in selling Geon stock" to his customers" (III.235).

9/ At the trial (IV.578-579) a stipulation was entered between counsel, which is reflected in SEC Exhibit 17, 109a-116a, with regard to the purchases and sales of Geon stock from October 18, 1973, through February 22, 1974, that are relevant to this case. In addition to transactions designated as "Rauch (wife)" (e.g. 109a) that exhibit shows

(footnote continued)

law. (V.763).[10] And 6,150 additional shares were purchased by Mr. Rauch for the accounts of various others of his customers. (SEC Exhibit 17, 109a-110a).[11]

At Mr. Rauch's request (III.237), Mr. Neuwirth agreed to meet Mr. Rauch for lunch on Wednesday, November 21, 1973. (III.246-247). At that time Mr. Rauch asked "nosey" "broker's questions" about the corporation and Mr. Neuwirth suggested that he and Mr. Rauch move away from the bar so that the bartender could not overhear what was discussed (III. 249). In the ten days following his luncheon meeting with Mr. Neuwirth,[12]

(footnote continued)

transactions in the name of "B. Rauch" and "Beverly Rauch," which the exhibit shows to be Mr. Rauch's wife (111a). Exhibit 17 further reflects a substantial number of transactions for "Rauch (Rosalyn)" or "Rosa. Rauch" (110a-113a) and two large purchases for one "Jules Rauch" (111a-112a), whom we presume to be members of Mr. Rauch's family.

10/ On October 22, 1973, Mr. McMahon had purchased 100 shares of Geon's common stock (SEC Exhibit 17, 109a) in an account that he had opened at the Hewlett branch office of Edwards & Hanly through Mr. Rauch (IV.620-624). Mr. McMahon had stated on the new account card that he was employed by the accounting firm of Arthur Anderson & Co., thereby concealing his relationship with Geon through its subsidiary (IV.629).

Subsequently, on November 1, 1973, Mr. Rauch submitted an account card completed in the name of Louis Maione, Mr. McMahon's father-in-law. (SEC Exhibit 19, 119a). This card was false and misleading because it failed to disclose that Mr. McMahon controlled the account (V.763).

11/ 1,200 of these shares had been purchased for "Rosa. Rauch" (110a).

12/ Some time after their lunch, Mr. Rauch sent two bottles of liquor to Mr. Neuwirth as a gift (III.259-260).

Mr. Rauch purchased 3,600 shares of Geon stock for his customers in 13 separate transactions (SEC Exhibit 17, 111a).[13/]

By this time, in early December of 1973, there were public rumors "that a company was looking at Geon" and the market in Geon's stock had begun to behave "very unusually," (II.51, III.390). For these reasons, the American Stock Exchange asked Frank Bloom whether there were any unusual corporate activities, and upon learning of Geon's discussions with Burmah, the Exchange informed Geon that a public announcement was advisable. (III.390). Accordingly, Geon issued a press release on Monday, December 3, 1973, which for the first time publicly announced its "preliminary" acquisition discussions with Burmah. (II.46, 52; SEC Exhibit 1, 75a). Apparently, Mr. Neuwirth had telephoned Mr. Rauch "after business hours" (III.257) at his home the preceding Friday (III.256-257). Between December 3 and December 20, 1973, Mr. Rauch purchased 1,600 shares of Geon's common stock for himself and his wife and 14,200 shares for various of his customers (SEC Exhibit 17, 111a-113a).[14/]

13/ Of these shares, 200 were purchased for the account of "Rosa. Rauch" (111a).

14/ Of the Geon shares purchased during this period, 2,000 shares were purchased by Mr. Rauch for "Jules Rauch" (111a-112a) and 400 shares were purchased for "Rosa. Rauch" (112a).

Negotiations on the purchase price to be paid by Burmah for Geon were held on December 17 and 18, 1973, in New York City, (II.55-59, 65-66; III.264-265), and Geon's officers agreed to an acquisition price of $36,000,000 (II.67; III.269). On December 18, 1973, Geon issued a public announcement that its "preliminary" negotiations with Burmah were continuing (II.60; SEC Exhibit 2, 76a), and on December 20, 1973, Geon issued a third press release, announcing that its Board of Directors had approved "in principle" the acquisition of Geon by Burmah (II.68; SEC Exhibit 3, 77a). That release referred not only to the $36,000,000 figure but also noted that "after the payment of expenses related to the acquisition" this would "be approximately $16.80 per share" (SEC Exhibit 3, 77a). During the two weeks preceding this announcement the market price of Geon stock had varied between $10.75 and $13.75 per share (Edwards & Hanly Exhibit 9, 142a).

On December 21, 1973, the day after the Geon announcement, Mr. Rauch purchased another 2,500 shares of Geon stock for his customers in eight separate transactions. From then to the end of December he purchased 700 additional shares for his customers' accounts (SEC Exhibit 17, 113a).[15/]

15/ Of these, 200 shares were purchased for the account of "Rauch (Rosalyn)" (113a).

Thereafter, representatives of Geon and Burmah prepared a succession of draft purchase agreements on December 31, 1973, during January, 1974 and February 13, 1974 (II.114). During January of 1974, while the purchase agreement was being drafted Mr. Rauch telephoned Mr. Neuwirth very frequently (III.277) but did not purchase any Geon securities until February 1, 1974, when 500 shares were purchased for the accounts of two customers (SEC Exhibit 17, 114a).

On about February 10 and February 14, Mr. Rauch spoke by telephone with Mr. Neuwirth (III.278).[16/] On February 15, 1974, a special meeting of Geon's Board of Directors was called for February 21, 1974, to consider the proposed purchase agreement between Geon and Burmah (II.114-115; SEC Exhibit 9, 83a). The fact of the meeting was not publicly disclosed (III.280). Mr. Neuwirth testified that he could not remember whether he told Mr. Rauch that the merger contract was about to be approved (III.278); Nevertheless, on February 19, 1974, Mr. Rauch purchased 1,000 shares of Geon's securities for his wife (SEC Exhibit 17, 114a).

16/ On February 11, Mr. Rauch purchased 500 shares in Geon for one of his customers (SEC Exhibit 17, 114a).

On February 20, 1974, the night before the special meeting of Geon's Board of Directors, George Neuwirth again had dinner with Mr. Roy Alpert (III.281). During the course of their dinner Mr. Neuwirth revealed the upcoming meeting to Mr. Alpert and stated that the Board was going to "rubber stamp an agreement." (III. 282, 331). Mr. Alpert, who had purchased another 1,000 shares of Geon's common stock on December 19, 1973, (III.330) left dinner with an assumption that the Burmah transaction "was such an important event that if [Mr. Neuwirth] signed the papers, if the deal was going through, . . . that [Mr. Neuwirth] would call me . . . ." (III.333).

<u>Discovery of possible accounting errors and the board meeting of February 21, 1974</u>

In anticipation of the Board of Directors' meeting, Mr. Bloom directed his accounting staff to assemble preliminary financial information respecting Geon's earnings for 1973. (II. 78). At about 10:30 on the morning of February 21, 1974, Mr. Bloom learned from Stanley Chin, an assistant controller at Geon, that there was a possible accounting error involving an inter or intra company net profit elimination amounting to $314,000. (II.79-80). Later that day, Mr. Bloom learned that the preliminary earnings figures on several of Geon's branch operating divisions were lower than had previously been esti-

mated, indicating a potential combined gross earnings shortfall of $700,000. (II.117-118). In addition, the preliminary reports indicated that the earnings from Geon's aircraft export division were "off" about $180,000, raising the total possible error in expected net income to about $1,194,000 (II.122-123). Inasmuch as the acquisition contract between Geon and Burmah, which was to be approved by Geon's Board of Directors that afternoon, imposed a minimum income requirement on Geon for the year 1973 (II.116; 84a-87a), Mr. Bloom was concerned by the preliminary figures (IV.541) because the $700,000 gross earnings shortfall alone, if confirmed, would have voided the negotiated contract (II.118; IV.500).

At the Board of Directors' meeting, Mr. Bloom informed the Board of the apparent accounting errors and their implications with respect to the Burmah agreement, but cautioned that the figures could not be verified until the following Sunday, February 24, 1974. (III.127). Concerned that a "rumor" might reach the public after the meeting, Geon's counsel decided that the market should be monitored the next day for any "unusual activity." (II.128; IV.538-539).

After the Board meeting, Mr. Bloom returned to Geon's offices and worked with Mr. McMahon until after midnight. (II. 129, 157). They were able to confirm that the $314,000 error in failing to eliminate intra-company net profits had been made

(II.129), but Mr. Bloom was unable to complete his analysis of the apparent $700,000 gross earnings shortfall (III.158-159). No attempt was made to confirm the $180,000 reduction in earnings of the import-export division, because it had not been entirely unexpected (II.123).

In the small hours of the morning, upon arriving home, Mr. McMahon awakened Mr. Rauch by telephoning him to instruct him to sell all of Mr. McMahon's holdings in Geon as well as the Geon common stock held in Louis Maione's account, see <u>supra</u>, pp. 11-12 (70a; IV.543).

<u>Mr. Bloom's conversation with an official of the American Stock Exchange; the sharp decline in the market price of Geon's common stock; and sales of Geon stock by Mr. Rauch and others</u>

Before trading on the American Stock Exchange commenced on February 22, 1974, Mr. Rauch advised Martin Rosenfeld, the resident partner at the Hewlett, New York, branch office of Edwards & Hanly where Mr. Rauch was employed, that he had 1,500 shares of Geon's common stock to sell (IV.684).[17/] As he had done in

---

17/ Between mid-October, 1973, and February 21, 1974, Mr. Rauch did not sell any of the Geon common stock that he had purchased for himself or his wife. For reasons not disclosed in the record, five customers sold an aggregate of 1750 shares during that four-month period (SEC Exhibit 17, 115a).

the past (IV.609), Mr. Rauch demanded that his order be specially processed (IV.684-685) and that Mr. Rosenfeld telephone the sell order directly to the exchange in New York (IV.685-686), which was done.

At about the same time, David Scott Foster, a floor official at the American Stock Exchange ("AMEX")(IV.448-449), was advised by Dennis Poster, a trading specialist for the AMEX (IV.449-450), that the pre-market activity in Geon was "unusual" because there were outstanding orders to sell approximately 10,000 shares of Geon's common stock (IV.449-450). Accordingly, Mr. Foster telephoned Randy B. Gromet, a senior listing representative employed at the AMEX (III.364, 366; IV.452) and a decision was made to delay the opening of trading in Geon's stock in order to permit Mr. Gromet to inquire whether there were any corporate developments that would account for the activity (III.367-368; IV.452). Mr. Gromet immediately telephoned Mr. Bloom (III.368), the Geon officer to whom Mr. Gromet had directed previous inquiries (II.52; III.368, 390), and who had been designated by Mr. Neuwirth to answer questions from analysts (III.241-242), and to confirm press releases (SEC Exhibit 1, 2 and 3, 75a-77a).

When he learned that Mr. Gromet was telephoning, but before accepting his call, Mr. Bloom immediately telephoned a member of the law firm that represented Geon (II.132-133; IV.521-522), who advised Mr. Bloom to tell the AMEX that the company had no announcement to make (II.135; IV.528). 18/

Mr. Bloom then accepted Mr. Gromet's telephone call and was informed that a large imbalance of sell orders existed in Geon's stock. (II.135; III.369). Mr. Gromet did not merely inquire whether there was anything to announce, but instead proceeded to ask Mr. Bloom specifically whether Mr. Bloom knew of any corporate developments that might account for the market activity and whether there had been any change in the status of the previously announced acquisition of Geon by Burmah. (II.135-136; III.369-372). Mr. Bloom advised Mr. Gromet "that there were no developments at the company which would account for selling" (III.369), "that there were no problems with the Burmah deal" (II.138), and that the Burmah transaction was not in danger or in any way jeopardized (III.369, 371). Mr. Gromet cautioned Mr. Bloom that he wanted to be sure of

---

18/ When this advice was given both the attorney and Mr. Bloom were apparently unaware of the existing imbalance of sell orders in Geon's securities at the AMEX. (IV.529).

these facts—that he

> "wanted to be sure that there was nothing pending, because the last thing in the world the exchange would want to see would be any kind of an announcement at all after a substantial sell off, or a substantial amount of volume in the stock" (III.371).

To which Mr. Bloom replied: ". . . Randy, the company definitely has no announcement to make today" (II.138).

After having been reassured by his conversation with Mr. Bloom, Mr. Gromet telephoned Mr. Foster and advised him that there was no information available from Geon "that should affect the price of the stock" (IV.452). Consequently, Mr. Foster informed the public that trading in Geon's stock would open in the range of 14-3/8 to 14-3/4 (IV.454), down 1/2 to 3/8 from the closing price the day before. (IV.453). By the time trading opened shortly after 10:30 (III.373), outstanding sell orders had risen to about 13,000 shares. (IV.453-454).

Within 10 to 15 minutes after trading opened, Mr. Rosenfeld had sold all the Geon stock held in the accounts that he managed (IV.690), David Lynn, the assistant manager at the Hewlett branch office of Edwards & Hanly, had begun to sell his Geon stock (IV.691; V.757), and Mr. Rauch had asked Mr. Rosenfeld to place an order to sell an additional 2,000 shares (IV.691). At approximately 9:30 that same morning, Mr. Roy Alpert, who

had expected George Neuwirth to confirm to him that the merger was going through, see p. 16, supra, had become "quite concerned over the fact that [he] hadn't heard from Mr. Neuwirth" and, therefore, discussed with his brother whether they should sell half of their holdings in Geon, about 4,000 shares. They decided to do so. (III.334, 336). Later that morning, Mr. Alpert and his brother determined it would be wise to dispose of the remainder of their holdings in Geon (III.335) since their broker advised them that he could sell the balance of their account for 14-3/8 share (III.336); this resulted in a net profit to the Alperts of about $9,000 (III.336).

As a result of the accounting report made at the Board of Directors' meeting the previous day, when trading commenced in Geon's common stock on February 22, 1974, Geon's counsel watched the market's activity. (V.852-854). When the market price declined to about $12 per share (IV.454-455) on heavy volume, Geon's counsel telephoned the AMEX at about 11:30, disclosed the apparent accounting errors that Mr. Bloom had earlier failed to reveal (III.377; IV.455), and requested that trading be halted; this was done (III.377-378; IV.455; V.854). In the

approximately one hour of trading that had occured before trading was suspended, however, Mr. Rauch had sold 4,400 shares of Geon stock held in his wife's name, 500 shares held in the account of "Rosalyn Rauch," and an additional 2,300 shares owned by some of his other customers, including 1,000 shares for the accounts of Mr. McMahon and his father-in-law, Mr. Malone; Mr. Rosenfeld had sold 1,200 shares, including 550 shares he had owned; and Mr. Lynn had sold 500 shares , including 100 shares of his own (SEC Exhibit 17, 116a).[19/]

On Sunday, February 24, 1974, Geon's Board of Directors met and was informed by Mr. Bloom that the preliminary accounting errors disclosed on February 21 had been confirmed (II.163-166). The next morning, representatives of Geon and the AMEX discussed the events of February 22, 1974, and a press release was issued acknowledging that Geon's 1973 earnings had been adversely affected and were "appreciably . . . below that on which Geon's agreement with Burmah Oil Incorporated was negotiated." (SEC Exhibit 10, 87a).

19/ We have assumed that the reference to a 600 share sale by "Malone" on February 22, 1974 at p. 116a, was intended to reflect a sale on that date by Mr. Malone, for whom 600 shares had been purchased in early October (90a-94a).

The supervision of Mr. Rauch by Edwards & Hanly

By February 22, 1974, as a result of purchases made both before and after having commenced his employment at Edwards & Hanly, Mr. Rauch had accumulated an aggregate of approximately 60,000 to 70,000 shares of Geon's common stock in the accounts of his customers and in his personal account. 20/ In fact, Mr. Rauch had become the Edwards & Hanly office expert on Geon (IV.653; V.741), to whom all inquiries concerning that company were directed. Mr. Rauch had also amassed "an extensive file of material on the company" including information that the office's assistant manager, Mr. Lynn, did not believe was available generally. (V.741). Accordingly, when Mr. Rauch started to sell Geon stock on February 22, 1974, both Mr. Rosenfeld, the resident partner of the firm, and Mr. Lynn followed his example, contributing to the imbalance of sell orders driving down the market price of Geon's common stock.

When Mr. Rauch had accepted a position with Edwards & Hanly in August of 1973 (IV.5[illegible]8), Mr. Rosenfeld was aware that Mr. Rauch then held about 25,000 to 30,000 shares of Geon stock in his own account and in the accounts of customers (IV.600). 21/

20/ At that time, there were approximately 3,000,000 shares of Geon's common stock outstanding. (SEC Exhibit 14, 90a).

21/ Mr. Rosenfeld had not, however, asked for a statement of Mr. Rauch's investments, assets or liabilities (IV.599).

Mr. Rauch appears to have been hired primarily on the basis of his past sales record and the large number of accounts he might bring with him (IV.598-599); 22/ the very substantial holdings of Geon's stock in his account and the accounts of his customers were a positive factor, since it indicated that Mr. Rauch "had accounts of some substance that could perhaps generate commissions. . . ." (IV.601). At that time, however, Geon's common stock was not eligible for trading at Edwards & Hanly because its market price was under $15 per share. (IV.604). But on Mr. Rauch's very first day in the office Mr. Rosenfeld secured an oral exemption from this restrictive rule pending an analysis of Geon by Edwards & Hanly's research department (IV.605). Thereafter the research department recommended that Geon's stock be considered eligible for trading at Edwards & Hanly. (V.726; Edwards & Hanly Exhibit F, 126a).

22/ When Mr. Rauch joined the Hewlett branch office, he had brought with him over 100 accounts. In fact, there were so many that Mr. Rauch, his wife and his former secretary had to work together to complete the "new accounts cards" (V.711), that were submitted to the firm for approval. As we have observed, supra, n. 10, two of the account cards submitted by Mr. Rauch, which are relevant to this case, contained false information.

After Mr. Rauch received oral permission to conduct transactions in Geon's stock, the volume of trading in Geon at the Hewlett office of Edwards & Hanly became so heavy that Raleigh Gilbert, a partner in the brokerage firm (V.774). "flashed . . . a caution sign . . ." to Mr. Rosenfeld (IV.657), warning him that the accumulation of stock in Geon at the Hewlett office was "growing" and instructing Mr. Rosenfeld to "stay on top of the situation." (V.777, 788). Despite this admonition, Mr. Rosenfeld permitted Mr. Rauch to continue soliciting purchases of Geon's common stock. (IV.659). In addition, Mr. Lynn, who had started to trade in Geon's securities, was unaware of Mr. Gilbert's warning (V.747) and continued to purchase Geon stock. (SEC Exhibit 17, 109a).

Subsequently, in mid-November of 1973, the market price in Geon's common stock declined to about 8-3/4 from a high of 14-1/4 on November 2, 1973 (Edwards & Hanly Exhibit G, 142a), and the firm realized that maintenance calls on the Geon margin accounts might be required. (IV.658). Accordingly, Mr. Rosenfeld was directed by certain of his partners, Messrs. Gilbert, Patti, Edwards and Zollner, to make certain that the margin accounts were strong enough to support the fall in the market, to know the clients with whom his office dealt, to question Mr. Rauch about his trading and to inspect all orders before they were transmitted to the exchange. (IV.660-661). And he was instructed

if possible to "try not to add" to the firm's customers' positions in Geon (IV.662). Despite this explicit directive, however, Mr. Rosenfeld continued to permit Mr. Lynn and Mr. Rauch to solicit purchases of Geon's common stock, and in fact participated in the solicitations himself (IV.666-668; SEC Exhibit 17, 109a-110a).

Eventually, Mr. Rauch became the number one producer of net commissions in the Hewlett office (IV.607-609). And Mr. Rauch requested and received special treatment at the office (IV. 609). Mr. Rosenfeld was so impressed with Mr. Rauch's talents as a salesman that he did everything possible to make Mr. Rauch happy and favored him over other employees (IV.611, 613). For example, Mr. Rauch could telephone orders to the main wire room while other account executives would have their orders processed over the wire services (IV.609-610; V.706-707). Also Mr. Rauch was given preferential seating behind the assistant manager, who was requested to assist Mr. Rauch in learning about different classes of securities, such as municipal bonds and mutual funds (IV.611).

Mr. Rosenfeld was aware that in September or October 1973 Mr. Rauch had been talking with Mr. Neuwirth at Geon

(IV.646-647), although Mr. Rosenfeld testified that he had not inquired concerning the substance of those conversations (IV.649). In fact, after the announcement by Geon of a possible "merger" with Burmah, Mr. Rauch questioned Mr. Rosenfeld "almost on a daily basis" about his potential for obtaining fees from Geon for the solicitation of shares from his clients' substantial holdings if the merger should be effected. Mr. Rosenfeld "went to . . . [his] firm" and asked what his partners thought, and thereafter authorized Mr. Rauch to find out from Geon whether solicitation fees might be offered (IV.651). Significantly, Mr. Lynn, the assistant manager, could not recall any specific guidelines concerning contacts between representatives of his firm and the officers or directors of publicly traded companies (V.732), and Mr. Rosenfeld suggested the only restrictions to be that the firm's representatives could not claim to be investment advisers or securities analysts (IV.643-644).

ARGUMENT

I. THE DISTRICT COURT APPLIED AN ERRONEOUS LEGAL PRINCIPLE IN HOLDING THAT EDWARDS & HANLY DID NOT VIOLATE RULE 10b-5; THE DOCTRINE OF RESPONDEAT SUPERIOR MAY PROPERLY BE APPLIED TO HOLD THIS SECURITIES FIRM LIABLE FOR THE VIOLATIONS OF MR. RAUCH, ITS SALESMAN.

The District Court found (62a-63a)

> "that defendant Neuwirth violated Section 10(b) of the Exchange Act and Rule 10b-5 with respect to the furnishing of material non-public information to Rauch . . . during the period alleged in the complaint."

The evidence as we have seen, pp. 11-14, supra, is overwhelming that Mr. Rauch purchased a substantial number of Geon shares during the period that Mr. Neuwirth was supplying him with material non-public information concerning Geon; information that he knew was non-public. Accordingly, Mr. Rauch violated Rule 10b-5 when he made each of these purchases. Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F 2d 228, 237 (C.A. 2, 1974); Radiation Dynamics, Inc. v. Goldmuntz, 464 F. 2d 876, 887 (C.A. 2, 1972); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833, 852-53 (C.A. 2), certiorari denied sub. nom. Kline v. Securities and Exchange Commission, 394 U.S. 976 (1968). See also Kuehnert v. Texstar Corp., 412 F. 2d 700, 702-03 (C.A. 5, 1969).

Nevertheless, the district court rejected the Commission's contention that Edwards & Hanly, because of the illegal acts of its employee Mr. Rauch, should be held to have violated Rule 10b-5 under the doctrine of respondeat superior. Instead, the district court found no basis to enjoin Edwards & Hanly, holding that

> ". . . Edwards [& Hanly] acted in good faith and that the evidence fails to establish that Edwards [& Hanly] participated in or knew of Rauch's misconduct or that Edwards [& Hanly] did not exercise reasonable supervision over Rauch."

In treating this analysis as dispositive of the question of Edwards & Hanly's liability, the district court relied solely upon Securities and Exchange Commission v. Lums, Inc., 365 F.Supp. 1046, 1064-1065 (S.D.N.Y., 1973), which had held that "the appropriate standard for liability" of a broker-dealer firm based upon the acts of an employee, committed in the course of his employment, is the controlling person provisions of Section 20(a) of the Securities Exchange Act, 15 U.S.C. 78t(a). Section 20(a) imposes liability upon a controlling person for the acts of persons controlled, but, unlike traditional agency principles, it permits as a defense a showing that "the

controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violations . . . ."

After the court below ruled in this case, however, this Court expressly rejected the narrow view of the responsibility of a broker-dealer for the acts of its employees that was articulated in Lums. In Securities and Exchange Commission v. Management Dynamics, Inc., Docket No. 74-1680, (C.A. 2, March 18, 1975), this Court held that "§20(a) was not intended as the sole measure of employer liability." Slip. op. p. 2351. It stated that

> "given the pervasive applicability of agency principles elsewhere in the law, it would take clear evidence to persuade us that Congress intended to supplant such principles by enacting the 'controlling person' provisions. Not only is such evidence lacking, but the statute itself suggests otherwise."

Thus, this Court recognized

> "that the 'controlling person' provisions were enacted to expand, rather than restrict, the scope of liability under the securities laws . . . . Control was defined in a broad fashion . . . to reach prospective wrongdoers, rather than to permit the escape of those who would otherwise be responsible for the acts of their employees" (id. at 2352, citations and footnote omitted).

And it observed that decisions of the courts of appeals in four other circuits have "applied agency principles to hold brokerage

firms liable for the acts of their employees," id. at 2352.[23/]

To be sure, this Court in Management Dynamics expressly declined to "decide . . . whether the entire corpus of agency law is to be imported into the securities acts for all purposes," id. at 2353. Nevertheless, it held a broker-dealer firm liable because of the trading activity of an employee; and the facts in the record at bar are no less compelling than the facts upon which that case was decided.

There can be no doubt on the record before this Court that Mr. Rauch was generally authorized to enter into his transactions in Geon stock and that during October and November 1973 each Geon transaction was specifically authorized by his immediate supervisor, Mr. Rosenfeld, a member of the Edwards & Hanly partnership (IV.581). Nor can it be disputed that the

---

23/ Citing John Hopkins University v. Hutton, 422 F. 2d 1124, 1130 (4th Cir., 1970); Lewis v. Walston & Co., 487 F. 2d 617, 623-24 (5th Cir., 1973); Armstrong, Jones & Co. v. SEC, 421 F. 2d 359, 361-62 (6th Cir.), cert. denied, 398 U.S. 958 (1970); Fey v. Walston & Co., 493 F. 2d 1036, 1051-53 (7th Cir., 1974).

The district court in Lums, 365 F. Supp. at 1063-64, seemingly believed that this Court's decision in Lanza v. Drexel & Co., 479 F. 2d 1277 (C.A. 2, 1973)(en banc) offered support for its erroneous conclusions. In Management Dynamics this Court pointed out, however, that "liability in the employment context is a vastly different situation from the liability of individual outside directors . . . ," which was the only issue addressed in Lanza. Slip. op. p. 2352, n. 8.

firm enjoyed profits from commissions generated during Mr. Rauch's long series of transactions in Geon stock, which were carried out in its name and through its facilities (IV.579). 24/ Neither is there any question that Mr. Rauch's repeated contacts with Mr. Neuwith were known to his employer and were condoned (IV.647, 649) if not actively promoted (IV. 651). Additionally, as we have seen, Mr. Rosenfeld and Mr. Lynn, both of whom were Mr. Rauch's supervisors (IV.581-584; V.731), chose to follow his lead in their own transactions in Geon stock (IV.690-691: V.757), although Mr. Lynn, at least, appears to have known or suspected that Mr. Rauch was trading on the basis of material non-public information (IV.741).

In this situation it is entirely appropriate for the doctrine of respondeat superior to be applied in order to find the firm violated Rule 10b-5 based upon the illegal acts of its employee. Under elementary agency law "[a] principal, although personally innocent, is liable . . ." for the wrongful acts of

---

24/ These facts distinguish the case at bar from Gordon v. Burr, 506 F. 2d 1080 (C.A. 2, 1974). As this Court observed in Management Dynamics, supra, at p. 2353: "In that case liability could not have been imputed under agency principles, since no one connected with the transaction was acting on behalf of the brokerage firm."

its agent as actually authorized, apparently or ostensibly authorized, or within his agency powers. Restatement (Second), Agency, §257 and comment b, §261 and comment a (1957). And an act may be within the scope of the agent's employment even though it be consciously criminal or tortious. Restatement (Second), Agency, §231 and comment b; United States v. Arrow Packing Corp., 153 F.2d 669 (C.A. 2), certiorari denied, 327 U.S. 805 (1946); Mosley v. Snider, 160 F.2d 105 (C.A. 6, 1947).

This Court and other courts of appeals have expressly or implicitly applied agency principles to corporate broker-dealers See, e.g., Securities and Exchange Commission v. Management Dynamics, Inc., supra, Slip. op. p. 2352; Securities and Exchange Commission v. Rapp, 304 F. 2d 786, 790-791 (C.A. 2, 1962); Securities and Exchange Commission v. Charles A. Morris & Associates, Inc., 1972-1973 CCH Sec. L. Rep. ¶93,756 at pp. 93,306-93,307 (C.A. 6, 1973).

The principle of respondeat superior is equally applicable where, as here, a partnership must be charged with the wrong-doing of its agent. In United States v. A & P Trucking Co., 358 U.S. 121, 124 (1958), the Supreme Court made clear that if the policy of a regulatory statute is to be effectuated the unlawful acts of agents must be attributed to their principals, and

> ". . . it certainly makes no difference whether the [entity] which commits the infraction is organized

> as a corporation, a joint stock company, a partnership, or an individual proprietorship. The mischief is the same, and we think that Congress intended to make the consequences of infraction the same."

Accord: United States v. Hilton Hotels Corp., 467 F.2d 1000, 1004 (C.A. 9, 1972), certiorari denied, 409 U.S. 1125 (1973).

In the A & P Trucking case the Supreme Court considered whether a carrier, organized as a partnership, could be found guilty of "knowing" or "willful" violations of certain regulations promulgated by the Interstate Commerce Commission. The Court termed it "elementary" that a corporation or other association might be found "guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of respondeat superior," id. at 125, and it concluded that the same principle was applicable to partnerships, holding "that a partnership can violate each of the statutes here in question quite apart from the participation and knowledge of the partners as individuals," id. at 126-127. The Court emphasized, id. at 126, that, regardless of the form of organization:

> "The policy to be served . . . is the same. The business entity cannot be left free to break the law merely because its owners, stockholders . . . [or] partners . . . do not personally participate in the infraction. The treasury of the business may not with impunity obtain the fruits of violations which are commited knowingly by agents of the entity in the

> scope of their employment. Thus pressure is brought on those who own the entity to see to it that their agents abide by the law."25/ (footnotes omitted)

Consistent with these principles the Commission has long applied a similar doctrine in administrative proceedings to support remedial action taken against a partnership that is a registered broker-dealer whose employees had committed illegal acts within the scope of their actual or apparent authority, Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961); Reynolds & Co., 39 S.E.C. 902, 916 (1960); A.F. Schroeder & Co., 27 S.E.C. 833, 837 (1948). And the courts have expressly and implicitly sustained the Commission's application of this doctrine, e.g., Armstrong, Jones & Co. v. Securities and Exchange Commission, 421 F. 2d 359, 362 (C.A. 6), certiorari denied, 398 U.S. 958 (1970). Moreover, the principle has been applied in private actions brought to obtain damages for violations of the securities laws. Thus, in Fey v. Walston & Co., 493 F. 2d 1036 (C.A. 7, 1973),

---

25/ This is not to say that members of the firm who are not shown individually to be culpable may be considered to have individually violated the law. To the contrary, as the A & P Trucking case makes clear, 358 U.S. at 127,

> "the conviction of a partnership cannot be used to punish the individual partners who might be completely free of personal guilt. As in the case of corporations, the conviction of the entity can lead only to a fine levied on the firm's assets."

Comparably, in the case at bar, the individual members of the partnership would be enjoined only in their partnership capacity and would not continue to be subject to the injunction if they should leave the firm. See Rule 65(d) of the Federal Rules of Civil Procedure.

the court of appeals held a broker-dealer liable for illegal churning of customer accounts by its salesmen by "application of the common law principle" of respondeat superior, id. at 1052; and in Johns Hopkins University v. E.F. Hutton, 422 F. 2d 1124, 1130 (C.A. 4, 1970), a partnership was found to be liable for damages although the partners of the defendant broker-dealer had not participated in or had knowledge of the illegal misrepresentations of its employees.

II. ON THE RECORD BELOW THE DISTRICT COURT SHOULD HAVE HELD EDWARDS & HANLY LIABLE AS AN AIDER AND ABETTER OF MR. RAUCH'S VIOLATIONS.

As we have noted supra p. 30, the court below held that "the evidence failed to establish that Edwards [& Hanly] participated in or knew of Rauch's misconduct" (71a). Since, as we have shown, Edwards & Hanly violated Rule 10b-5 by virtue of the doctrine of respondent superior, it was unnecessary to show the firm's active participation in or knowledge of Mr. Rauch's misconduct. Nevertheless, the record does not support the court's conclusion as to the firm's lack of knowledge and participation. Indeed, it shows that under applicable principles the firm was an aider and abetter of Mr. Rauch's misconduct. In Securities and Exchange Commission v. Spectrum Ltd., 489 F. 2d 535, 541 (C.A. 2, 1973) (emphasis added, footnote omitted), this Court held that a standard for aiding and abetting that required actual

knowledge and intent to assist violations would be

> "a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief. SEC v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1096 (2d Cir. 1972); Hanly v. SEC, 415 F. 2d 589, 596 (2d Cir. 1969); SEC v. Texas Gulf Sulfur Co., 401 F. 2d 833, 854-855 (2d Cir. 1968)(en banc), cert. denied, sub nom. Kline v. SEC, 394 U.S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1969). Cf., Lanza v. Drexel, 479 F. 2d 1277, 1304 (2d Cir. 1973)(en banc)."

And this Court explicitly noted that it had "enunciated the negligence test principally in cases involving the antifraud provisions of the securities laws . . . ." Id. at 541 n. 12.[26/]

As we have seen, supra p. 27, Mr. Rosenfeld, a member of the firm, was highly impressed by Mr. Rauch's talents as a commission-generating salesman and compromised normal firm procedures at every turn in an attempt to assure that Mr. Rauch would be happy at his job. Although he lacked seniority, Mr. Rauch was given preferential seating behind the assistant manager (V.611). While other salesmen had their orders teletyped to the appropriate exchange (IV.685), Mr. Rauch received permission "to call in orders to [Edwards & Hanly's] main wire room if they were of substance, if they were of any type of

---

26/ See also, R.A. Johnson & Co., 36 S.E.C. 467, 485-486 (1955), affirmed, 231 F. 2d 523 (C.A.D.C.), certiorari denied, 352 U.S. 844 (1956).

size, or if it was in a security that was particularly thin as far as volume is concerned." (IV.609).

Furthermore, Edwards & Hanly's attempt generally to facilitate the solicitation of business by its registered securities representatives led it to adopt a tolerant approach to personnel management. For example, it was the firm's policy that an account card had to be completed for each customer and approved by the manager or assistant manager (IV.614). The customer was not required, however, to sign the account card (IV.625-626) or to present himself at an Edwards & Hanly office at any time in connection with the opening of a new account (IV.634, 635-637). In fact, "a tremendous majority of . . . [the] new account forms . . . [were] filled out via telephone conversations" (IV.615). Moreover, the firm relied upon the integrity of the account executive with respect to the information set forth on a new account card (IV. 614-615; V.733-734); only "a small percentage" of the information on new account cards was ever checked (IV.619) — and even this was apparently done mostly by a secretary (V.733). Moreover, no signed agreement was required by the firm before a customer could purchase securities on margin (IV.632, 635). And the "credit worthiness" of a margin-account customer was not con-

sidered a sufficiently important factor to warrant any greater verification than was given to cash accounts (IV.619-620). The superficiality of these procedures made it possible for James McMahon to open two accounts based on false information, which facilitated his sale of Geon's common stock on February 22, 1974, based upon Mr. McMahon's knowledge of material non-public information about Geon's accounting problems. See n. 10, supra.

Moreover, as we described above, pp. 26-27, Mr. Rosenfeld also ignored clear indications that Mr. Rauch might be trading based on material non-public information, twice failed to acknowledge or follow the instructions given to him by his senior partners to restrict future purchases of Geon's securities and participated himself in the purchase of Geon's common stock, thereby compromising the objectivity he would need fairly to evaluate Mr. Rauch's Mr. Rauch's conduct.

In light of all this evidence, the district court's conclusion "that the evidence fails to establish . . . that Edwards [& Hanly] did not exercise reasonable supervision over Rauch" (71a) is clearly erroneous, particularly in the absence of any substantial evidentiary support for the district court's apparent view that significant oversight was exercised.

For example, the district court referred (17a) to "detailed compliance manuals, which . . . [Edwards & Hanly] personnel are required to maintain and study," and to a "Guide for Opening and Managing Accounts for Account Executives." While there was testimony that certain manuals existed (V.697-698, 702-704), there was no significant testimony concerning the substance of what those manuals contained,[27/] and the manuals themselves were not received in evidence nor even physically retained by the district court.[28/] Accordingly, the district court had no more basis in the record to assume that these manuals promoted compliance than it would have had to assume that they promote fraud, if that had been its conclusion.

27/ Mr. Rosenfeld testified concerning the nature of some of his suprevisory responsibilities (V.697-705), but there is no evidence of the manner in which he performed those responsibilities, except to the extent that Mr. Rauch's unlawful activities with respect to Geon stock, and Mr. Rosenfeld's "supervision" of those activities, may be indicative.

28/ To a suggestion that these manuals might be submitted to this Court for consideration, counsel for Edwards & Hanly noted that the manuals "were marked for identification . . . [but] were not received into evidence" and that the manuals "are not part of the record on appeal . . . ." Letter from Evan L. Gordon, Esq. to Van P. Carter, Esq. dated February 18, 1975.

Where a tendered exhibit was not received into evidence and is not included in the record on appeal, neither the trial court nor the court of appeals can consider the probative value of the exhibit. Miles v. Ryan, 484 F.2d 1255, 1261 n.4 (C.A. 3, 1973); Creason v. American Bridge Co., 384 F.2d 475, 478 (C.A. 10, 1967).

The district court also noted that Mr. Rauch had been instructed to become familiar with the contents of at least one of these manuals (69a); but there is no evidence that Mr. Rauch had ever so much as read the manual. Moreover, since the manual's contents are not in the record, even if Mr. Rauch's familiarity with the manual had been shown, the significance of that fact could not have been evaluated by the court below. Similarly, there is no evidence by which the court below could have judged the efficacy of the instructional classes that Mr. Rauch was said to have attended (69a), since the record does not reveal either the subjects discussed, or the completeness of the discussion from the viewpoint of the firm's responsibility properly to supervise its employees.

Finally, while the record supports a finding that Mr. Rauch had been "monitored . . . by [the] compliance department" for perhaps thirty minutes on one occasion during the first six months of his employment at Edwards & Hanly (V.704-705), the record does not indicate on what matters he was questioned or whether his answers were deemed adequate. Indeed, it is not apparent from the record that Edwards & Hanly perceived what true compliance with the securities laws entailed insofar as it relates to supervision of sales personnel.

In short, the district court looked solely to the form of Edwards & Hanly's compliance procedures, ignoring the complete lack of evidence indicating that those procedures had any substance. Cf., Securities and Exchange Commission v. W.T. Howey Co., 328 U.S. 293, 300 (1946).

III. THE DISTRICT COURT ERRED IN NOT ADMITTING IN EVIDENCE AGAINST EDWARDS & HANLY THE INVESTIGATIVE TESTIMONY OF MR. RAUCH.

When Mr. Rauch was called as a witness at the trial, he invoked his Fifth Amendment privilege and refused to testify (III.360-363). Accordingly, the Commission sought to introduce as evidence transcripts of testimony Mr. Rauch had given under oath in the course of the Commission's investigation that preceded this action (III.361-362; SEC Exhibit 16 and 16A). Because Mr. Rauch had not been cross-examined in the Commission's investigation, however, the district court thought it "might be unfair to the defendants" for him to look at the transcripts. For that reason, the court excluded Mr. Rauch's investigative testimony from the record (V.865).

The district court was plainly in error in totally excluding the transcripts. At the very least, the transcripts of Mr. Rauch's investigative testimony should have been received in evidence against Mr. Rauch (who did not consent to an injunction until after the trial) as the admissions of a party opponent. 29/

29/ 4 Wigmore, EVIDENCE §§1048-1049, 1052-1053 (1972); McCormick, EVIDENCE §§262-263, 266 (2nd Ed. 1972). See, Community Counseling Services, Inc. v. Reilly 317 F. 2d 239, 243 (C.A. 4, 1963); accord, Fey v. Walston & Co., Inc., 493 F. 2d 1036, 1046 (C.A. 7, 1974). The well-established rule that admissions of a party opponent is not hearsay has recently been adopted as Rule 801(d)(2)(A) of the Federal Rules of Eivdence, effective July 1, 1975, P.L. 93-595, 88 Stat. 1939, January 2, 1975.

The transcripts were also admissible against Mr. Rauch as declarations against his interest, since the testimony was contrary to his pecuniary and propriety interests and he had rendered himself unavailable to testify at trial by invoking the fifth amendment.[30/]

Significantly, the transcripts should also be held admissible against Edwards & Hanly, since the declarations of Mr. Rauch made within the scope of his employment are admissible as admissions of his employer. Cf., Pan-American Pet. & Trans. Co. v. United States, 273 U.S. 456, 498-499 (1927); Cox v. ESSO Shipping Co., 247 F. 2d 629, 632-633 (C.A. 5, 1957). Where as here an employee's statement is contrary to his own interests as well as the interests

---

30/ 5 Wigmore, EVIDENCE §§1455-1477 (1974); McCormick, EVIDENCE §276; Trade Development Bank v. Continental Ins. Co., 469 F. 2d 35, 42 (C.A. 2, 1972); Oscar Gruss & Son v. Lumberman's Mut. Cas. Co., 422 F. 2d 1278, 1283 (C.A. 2, 1970); Vaccaro v. Alcoa Steamship Co., 405 F. 2d 1133, 1137 (C.A. 2, 1968); Gichner v. Antonio Troiano Tile & Marble Co., 410 F. 2d 238, 241 (C.A.D.C., 1969); United States v. Elmore, 423 F. 2d 775, 778 (C.A. 4, 1970); United States v. Mobley, 421 F. 2d 345, 350-351 (C.A. 5, 1970); Mason v. United States, 408 F. 2d 903, 904 (C.A. 10, 1969).

of his employer it is very likely to be reliable; moreover, it is "as much a part of an employee's duty to account to public authority for the manner in which those duties were discharged as it would be to account or report to the employer." Koninklijke Luchtvaart Maatschappij N.V. KLM Royal Dutch Airlines Holland v. Tuller, 292 F. 2d 775, 782-785 (C.A.D.C.) certiorari denied, 368 U.S. 921 (1961) (hereinafter referred to as the KLM case).

We appreciate that this Court has previously taken a different view, see Northern Oil Co. v. Socony Mobil Oil Co., 347 F. 2d 81, 85 (C.A. 2, 1965). But the recently enacted Federal Rules of Evidence, consistent with the cases noted above, treat as an admission by a party opponent, and therefore not hearsay, "a statement by his agent or servant concerning a matter within the scope of his agency or employment made during the existence of the relationship." Rule 801(d)(2)(D), 88 Stat. 1939 (emphasis added). As the notes of the Advisory Committee on the adoption of these rules point out, "few principals employ agents for the purpose of making damaging statements," and "valuable and helpful evidence" is often lost as a result of excluding evidence under a strict scope-of-employment test. For this reason, the Federal Rules will follow the "substantial trend . . . admitting statements related to a matter

within the scope of the agency or employment." See Proposed Federal Rules of Evidence, Supreme Court Advisory Committee's Notes 56 FRD 183, 298 (1972).

The case at bar demonstrates the merits of abandoning the more restrictive rule. Examination of the transcripts of Mr. Rauch's testimony would have permitted the court below better to understand and evaluate the facts of the underlying transactions.[31/] For example, Mr. Neuwirth's memory of his telephone conversations with Mr. Rauch, the only securities salesman who had telephoned him (II.260-261), failed him when he was questioned concerning November of 1973 (III.237, 253, 255). The Commission was prepared to show through Mr. Rauch's investigative testimony, however, that Mr. Neuwirth "confirmed to me that there [was] a deal cooking sometime in November . . . ."

31/ In the KLM case, supra p. 45, the court of appeals emphasized the probative value of an admission made by an employee that had been introduced in evidence against his employer, which it was argued, should have been excluded from evidence. In that case, as in the case at bar, there was no question concerning what the employee had said, since there as here, the employees testimony had been recorded.

(SEC Exhibit 16 at p. 33, 102a). 32/ Mr. Neuwirth further could not remember whether he had given Mr. Rauch advance notice that Geon was about to announce its merger negotiations with Burmah (III.258). But, if admitted, Mr. Rauch's investigative testimony would have shown that Mr. Neuwirth had telephoned him at home on the Friday night before Geon's public announcement of its merger negotiations with Burmah (SEC Exhibit 1, 75a)

> "to tell me that Monday morning, before the opening [of trading in Geon] . . . there will be an announcement . . . that we [Geon] are having negotiations with Burma [sic] Oil of England."

(SEC Exhibit 16 at p. 34, 103a). Moreover, Mr. Rauch's sworn investigatory testimony reflects his admission that he was privy to material non-public information when he placed Mr. McMahon's order on February 22, 1974, to sell all of his and Mr. Maione's holdings in Geon stock. (SEC Exhibit 16 at p. 53, 108a).

32/ Where one of the issues on appeal is whether the trial court properly refused to admit a document into evidence, that document constitutes part of the record on appeal and is properly before the court of appeals. Chicago & Eastern Illinois R. Co. v. Southern Ry. Co., 261 F.2d 394, 400 (C.A. 7, 1959). United States v. City of Brookhaven, 134 F. 2d 442, 446-47 (C.A. 5, 1943).

While for purposes of this Point III the Commission is referring to the probative value of Mr. Rauch's investigative testimony, care has been taken not to refer to the content of his investigative testimony at any other place in this brief.

IV. THE DISTRICT COURT ERRED IN FAILING TO FIND THAT MR. BLOOM HAD VIOLATED RULE 10b-5.

When he spoke to the representative of the American Stock Exchange before the market opened on February 22, 1974, Mr. Bloom said that there was no change in the status of the proposed merger transaction, and that there were no developments at the company which would account for the selling that he had been informed was about to occur (III. 369). The district judge (63a-67a) does not appear to have decided whether at that time Mr. Bloom had made "any untrue statement of a material fact" or had "omit[ted] to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" (Rule 10b-5(b)). Nor does the district judge appear to have considered whether Mr. Bloom had thus engaged in an "act, practice or course of business which operate[d] . . . as a fraud or deceit" (Rule 10b-5(c)) upon at least some of the persons who thereafter purchased Geon shares through the facilities of the Exchange.

Nevertheless, Judge Bonsal concluded that Mr. Bloom had not "violated the securities laws with respect to this conversation"

(66a). He seems to have reached this conclusion on the basis that Mr. Bloom had "acted in good faith" (66a), and with "reasonable care and prudence" (67a), apparently because "Geon had only raw, unverified information which might have been misleading had it been made public" (66)). But public availability of the information known to Mr. Bloom was not the issue. Unlike the situation in Securities and Exchange Commission v. Texas Gulf Sulfur Co., supra, 401 F. 2d 845, where a misleading news release was issued by the company on the basis of incomplete information, here misleading replies were made on behalf of the company to specific questions from the stock exchange on which its stock was traded and which was in a position to stop that trading. The question posed was whether it was a violation of the antifraud provisions of Rule 10b-5 for Mr. Bloom to have deceived the American Stock Exchange concerning his knowledge that the existing imbalance of orders to sell Geon stock might be based upon material nonpublic facts concerning the company.

Mr. Bloom knew that corporate insiders were aware that the previously-announced prospects for a merger were in jeopardy and that attempts by these insiders or their tippees to take

advantage of the knowledge could well have resulted in the heavy imbalance in sales orders, particularily since Mr. Bloom admitted that "[t]here was some discussion as the [directors'] meeting broke up indicating that the stock should be monitored the next day for any unusual activity . . ." (II.128). In fact, the Exchange suspected the possibility, which was why it had delayed trading in Geon stock and why it had called Mr. Bloom (IV.450-453). Significantly, when Geon's lawyers later that same morning became aware of the heavy sales pressure in the marketplace, they caused trading to be suspended and made the disclosures to the Exchange that Mr. Bloom had failed to make (IV.534-535; V.853-855).

The district judge noted "that [Mr.] Bloom sought and followed the advice of counsel in telling Mr. Gromet that Geon would have no public announcement to make on February 22, 1974" (66a). While this is true, it is also true that counsel was not aware of the heavy imbalance in sales orders when he gave this advice to Mr. Bloom in the thirty-second consultation that preceded Mr. Bloom's discussion with Mr. Gromet (IV.528-529). Nor was counsel then aware that Mr. Bloom would specifically be asked by the representative of the stock exchange whether there had been significant corporate developments

or any change in the status of the Burmah negotiations that might account for this imbalance. In any event, a denial after such an inquiry as here occurred is very different from a no-comment statement, which, in effect, is what counsel authorized. Accordingly, even if advice of counsel were of significance on the question of whether a violation occurred, which it is not, there is no support in the record for the view that Mr. Bloom had acted on the advice of any attorney when he made false and misleading statements to Mr. Gromet.

As we have seen, supra p. 22-23, the record is unambiguous that a significant portion of the selling pressure came from inside sources or persons trading in Geon stock that had directly or indirectly been influenced by insiders. Of the approximately 45,000 to 46,000 shares sold on the morning of February 22, 1974 (III. 447), Mr. Rauch had sold 4,400 shares for the account of his wife as well as 2,800 shares for the accounts of his customers, including 1,000 shares for the accounts of Mr. McMahon and his father-in-law (SEC Exhibit 17, 116a); Mr. Rosenfeld and Mr. Lynn sold 1,200 shares and 500 shares respectively (ibid.); and Roy Alpert and his brother, acting on the basis of Mr. Neuwirth's failure to confirm that the merger was going through, sold at least 8,000 shares (III. 334-336). These sales totaled 16,900 shares — more than 36% of

the shares that were sold that morning.

The heavy selling by the insiders and the tippees demonstrates that the information withheld from the Exchange was material information. As this Court stated in Texas Gulf Sulphur, supra, 401 F. 2d at 851, "a major factor in determining whether [information] was a material fact is the importance attached to [it] by those who knew about it." There, it was not known that the excellent results of one drill hole presaged a major ore strike, just as here it was not known whether the accounting errors that indicated reduced earnings would be confirmed, with an adverse effect upon the proposed merger. Accordingly, it is appropriate to evaluate materiality by the conduct of those persons who knew or had reason to suspect that a hitch had or might develop in the merger negotiation. See also Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1307 (C.A. 2, 1974).

This Court stated in the Texas Gulf Sulphur case, 401 F. 2d at 852:

> "The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event a major strike should materialize,

> but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected."

The basic test of materiality is "whether 'a reasonable man would attach importance . . . [to the fact misrepresented] in determining his choice of action in the transaction in question'" List v. Fashion Park, Inc., 340 F. 2d 457, 462 (C.A. 2, 1965) (original bracketed material). Accord: Affiliated Ute Citizen v. United States, 406 U.S. 128, 153-154 (1972); Radiation Dynamics, Inc. v. Goldmuntz, supra, 464 F. 2d at 887; Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 849. Under this standard,

> "material facts include not only information disclosing the earnings. . . of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."

Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 849 (emphasis added). In addition, as stated in Securities and Exchange Commission v. Shapiro, 494 F. 2d 1301, 1305 (C.A. 2, 1974), facts relating to future events become material "upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."

Consistent with these authorities, while the lack of confirmation might have affected the judgement of investors as to the weight to be given to the information known to Mr. Bloom, the information was intrinsically of such importance that it would necessarily have been given some weight by any reasonable investor who was aware of it. Accordingly, appropriate disclosure was required in any circumstance in which a failure to disclose "would operate as a fraud or deceit upon any person."

Because Mr. Bloom failed to make full disclosure to the Exchange it permitted trading to commence. In the hour of trading that ensued before Geon's lawyers caused trading to be suspended, many persons purchased shares of Geon stock who

lacked material information that was directly or indirectly available to those persons from whom they bought, such as Messrs. McMahon, Rauch, etc. If Mr. Bloom had told the whole truth to Mr. Gromet trading would presumably have been suspended pending clarification of doubtful matters by the company, as in fact occurred on the next trading day (SEC Exhibit 10, 87a), and no investors would have been injured. Thus, Mr. Bloom's action facilitated the fraud practiced by those sellers and on this basis must be held to have been a violation of Rule 10b-5.

Moreover, the record indicates that Mr. Bloom's false and misleading statements directly affected the price at which Geon stock was traded on the morning of February 22, 1974. The record shows that the opening price was set by the specialist based in part on Mr. Bloom's false statement "that there was no information available. . . that should affect the price of the stock. . ." (IV.452). Had the facts been publicly known that there was a significant risk, although as yet unconfirmed, that an accounting error had been made that might affect the merger, the specialist would likely have set the opening price much lower, if, indeed, trading in the stock had been permitted to commence at all on that date.

CONCLUSION

For the foregoing reasons, the decision of the court below should be reversed insofar as it dismissed the complaint as against defendants Frank Bloom and Edwards & Hanly.

Respectfully submitted,

Lawrence E. Nerheim
General Counsel

David Ferber
Solicitor

Richard E. Nathan
Assistant General Counsel

Van P. Carter
Attorney

March 1975

Securities and Exchange Commission
500 N. Capitol St., N.W.
Washington, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 24, 1975

3/26/75

A. Daniel Fusaro, Esq.
Clerk, United States Court of Appeals
for the Second Circuit
United States Courthouse
Foley Square
New York, New York 10007

Re: Securities and Exchange Commission v. Geon Industries, Inc., Civil Appeal Nos. 75-7010, 75-2657 and 74-2614

Dear Mr. Fusaro:

Pursuant to Scheduling Order No. 4 entered on March 11, 1975, and Rule 31(b) of the Federal Rules of Appellate Procedure, we have transmitted to the Court by registered mail twenty-five copies of the Commission's brief as appellant in the above styled and numbered appeals.

In addition, pursuant to Rule 25 of the Federal Rules of Appellate Procedure, I hereby certify that two copies of the Commission's brief have been served by first-class mail upon opposing counsel for all parties.

Sincerely,

Van P. Carter

Van P. Carter
Attorney

cc: Jay G. Strum, Esq.
Kay, Scholer, Fierman, Hays
& Handler
425 Park Avenue
New York, New York 10022

Evan L. Gordon, Esq.
Delson and Gordon
230 Park Avenue
New York, New York 10017

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

March 24, 1975

Jay G. Strum, Esq.
Kay, Scholer, Fierman, Hays
& Handler
425 Park Avenue
New York, New York 10022

Evan L. Gordon, Esq.
Delson and Gordon
230 Park Avenue
New York, New York 10017

Re: Securities and Exchange Commission v. Geon Industries, Inc., Civil Appeal Nos. 75-7010, 74-2657 and 74-2614

Gentlemen:

We have transmitted to the Court under separate cover twenty-five copies of our brief, as required by Scheduling Order No. 4 entered on March 11, 1975, and Rule 31(b) of the Federal Rules of Appellate Procedure. In addition, pursuant to Rule 25 of the Federal Rules of Appellate Procedure, I have enclosed two copies of the Commission's brief. For your convenience, I have also enclosed a copy of the slip opinion released on March 18, 1975, by the Court of Appeals in Securities and Exchange Commission v. Management Dynamics, Inc., et al. (No. 74-1680), which we cite in our brief.

Sincerely,

Van P. Carter

cc: A. Daniel Fusaro, Esq.
Clerk, United States Court of Appeals
for the Second Circuit
United States Courthouse
Foley Square
New York, New York 10007

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

May 22, 1975

A. Daniel Fusaro, Esquire
Clerk, United States Court of Appeals
for the Second Circuit
United States Courthouse, Foley Square
New York, New York 10007

Re: Securities and Exchange Commission v. Geon Industries, Inc., et al., Civil Appeal Nos. 75-7010, 74-2657, 74-2614.

Dear Mr. Fusaro:

The brief that the Commission has filed as appellant in Civil Appeal No. 75-7010 was poorly printed and for that reason is difficult to read. Accordingly, for the convenience of the Court we have reprinted the Commission's brief as filed and respectfully request that you permit the reprinted briefs to be substituted for the poorly printed briefs filed by the Commission on March 24, 1975. Twenty-five copies of the reprinted brief are enclosed for that purpose. 3-27-75

The enclosed reprinted brief is identical in every respect to the Commission's original brief, except that we have transposed the civil appeal numbers so that Civil Appeal No. 74-2614 is now in the upper right-hand corner of the cover.

I hereby certify that I have by mail served upon opposing counsel in these appeals two copies of the enclosed reprinted brief.

Sincerely,

Van P. Carter

Van P. Carter
Attorney

Enclosures

cc: Jay G. Strum, Esquire
Kay, Scholer, Fierman,
Hays & Handler
425 Park Avenue
New York, New York 10022

Evan L. Gordon, Esquire
Delson and Gordon
230 Park Avenue
New York, New York 10017